

Perspectives for Growth in British Columbia's Financial Sector



Ministry of
Consumer and
Corporate Affairs

Roberta Stewart, Minister

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Background Information
for a Consultative Process

Ministry of Consumer
and Corporate Affairs

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1. MINISTER'S INTRODUCTION

With release of this discussion paper on prospects for economic development for financial institutions, I am beginning a consultation process to determine what changes are required to ensure the continued vibrance of British Columbia's financial sector.

The ideas and suggestions described in this paper do not represent the Ministry of Consumer and Corporate Affairs' final word. In fact, my intent in emphasizing issues and questions, rather than solutions, is to avoid pre-empting discussion with industry and other representatives.

My goal is to ensure British Columbia builds a strengthened regulatory environment which promotes safety for the consumer and prosperity for the entrepreneur. I look forward to full and frank discussion on the questions which have to be answered to achieve that goal.

Actions of federal and provincial regulators affect British Columbia financial institutions, as do changes in international and domestic financial markets.

An increase in international competition caused by factors as diverse as internationalization of the money markets, increased use of automation with resulting economies of scale, and a deregulation trend, means many firms are now able to offer services previously not possible.

Within this context, the Government of British Columbia favours effective regulation and a continuing removal of barriers to entrepreneurship. Financial sector diversification, for example, is an option as long as customer protection and financial stability are not put at risk.

The balance between the goals of appropriate regulation and maximum economic development is never easy to achieve. Events of the 1980s have demonstrated that and have amplified the calls for reform. To begin the process of achieving that balance, I have set three objectives for the Ministry of Consumer and Corporate Affairs:

- ° to ensure British Columbia financial institutions retain opportunities to maintain and increase their share of markets in British Columbia and elsewhere;
- ° to increase the potential for Vancouver to develop as an international financial centre; and,

- ° to ensure there is a safe, flexible and progressive regulatory environment and that confidence of consumers, savers, and investors is maintained.

I invite financial institutions, business, consumer and professional groups to join my Ministry in discussing ways to address the challenge before us. Your input is a prerequisite to finalizing legislative and policy proposals to meet the objectives I have described.



Honourable Elwood N. Veitch
Minister of Consumer and
Corporate Affairs

2. ECONOMIC DEVELOPMENT

The Government of British Columbia is committed to fostering a strong service sector which will complement the resource, service and industrial sectors by providing domestic and export services.

How can the government work with industry to encourage British Columbians to provide more of the capital needed for economic development within the province? Is it possible for Vancouver to serve as an international financial centre? These questions will be considered as part of this consultation process.

The Government of British Columbia is also committed to supporting the Government of Canada's free trade initiative. Free trade discussions may affect the financial sector in this province. Will free trade increase competition and enable new financial services and products to be offered?

The financial sector is undergoing change at a pace which continues to accelerate. Advances in computerization and telecommunications mean that the world can no longer erect protectionist barriers. It is now possible to buy and sell stocks and bonds on world markets 24-hours-a-day. The marketplace is truly international in scope.

In the 1980s in particular, there has been a proliferation of financial products and services available to the Canadian investor. Whether planning for retirement, purchasing life insurance or registered retirement savings plans, participating in mutual funds or the stock market, or accessing a money machine, an increasing number of Canadians are concluding transactions in the financial marketplace.

Integration of financial institutions has also changed the marketplace. Financial giants such as the Laurentian Group, Power Corporation, and Trilon are operating a range of financial services firms. Genstar, which made its reputation as a real estate firm, purchased Canada Trust and Canada Permanent Trust and was purchased by Imasco. Corporate takeovers raise issues of concentration and foreign ownership.

A number of provinces have passed new trust company legislation. Ontario's legislation modernizes procedures and ensures that the capacity for owners to use financial institutions for personal gain is minimized. Quebec's Bill 75 allows insurance companies to create subsidiaries with power to offer other financial services.

The Government of Canada has introduced position papers and discussion papers to address diversification, better control and regulation. Although examination of these issues was well underway, the failure of the Canadian Commercial and Northland

Banks underlined their importance. The report of the Estey Commission will provide further impetus for regulatory reform.

British Columbia must be prepared to respond to future market forces. British Columbia has a vibrant financial community - credit unions, a strong, speculative stock market, securities, insurance, trust, real estate and banking institutions (see appendix iii). Further development can be achieved through co-operation and consultation with groups and individuals who may be affected. Safety, security, stability and location are factors which make the goal worth pursuing in British Columbia. Achievement is by no means a certainty. Feedback received during this consultation process will help plot our courses of action.

Specific benefits can be derived from an expanded financial sector:

- ° more jobs, higher quality jobs and career opportunities in the financial sector in British Columbia;
- ° greater capital availability for other British Columbia businesses; and,
- ° opportunities for growth in business and professional services to the financial sector.

Given the increasing internationalization of the financial markets, it is timely to consider the role British Columbia may be able to play. While British Columbia may not have the population or economic base to offer all international financial services, it may be able to take advantage of its Pacific Rim location in providing trade related financial services, such as export financing or marine insurance.

To further economic development, legislation respecting financial institutions needs review. Questions to be asked include:

- ° What changes do the general public want?
- ° Does the structure of capital markets in British Columbia prevent expansion of existing firms or entry of new firms?
- ° What opportunities for development can the financial sector identify, and how can the Government of British Columbia assist and support in these developments?
- ° Can consumer, saver, and investor confidence be protected and enhanced while opportunities for development are pursued?

Some of the issues surrounding industry diversification and client protection will be described in the pages which follow.

3. INDUSTRY DIVERSIFICATION: FACING THE CHALLENGE OF A CHANGING MARKETPLACE

Banks, trust companies, insurance firms, and investment dealers historically performed specific core functions. Under provincial jurisdiction, credit unions have offered retail banking services to members. In the last ten years, the separation of functions has eroded so it is not as easy to distinguish financial institutions by function.

Our Strategic Choice

Because it is part of a federal state British Columbia is limited in some of its choices. We can neither limit nor foster market entry without reference to federal and extraprovincial regulation. However, British Columbia can decide to move in a certain direction.

We could adopt an open market philosophy and ensure that our laws do not disadvantage any who wish to enter British Columbia and do business.

We could also concentrate on nurturing local strengths. We have a vibrant credit union sector and an expanding stock exchange supported by a committed group of investment dealers. Within this context, our laws could be tailored to ensure the largest possible market for British Columbia based financial institutions.

Or, we could consider a phased approach, protecting local industries for a transition period, and then later adopting a fully open market approach.

In making the choice, British Columbia must remember other provinces and the federal government have power to incorporate and regulate firms, and it is desirable that British Columbia firms be free to operate across the full Canadian commercial marketplace. Other key considerations include: safety of institutions and their customers, stimulation of economic development, fair treatment of our financial institutions -- both within and outside this province's jurisdiction, fair treatment of those who come to invest within this jurisdiction, and concerns raised about concentration and ownership.

Key Issues and Questions

Should mingling of functions continue? Is further diversification of financial institutions in the best interest of British Columbia?

Today it is not easy to identify the difference between banks and other financial institutions. More institutions are offering similar or identical services.

In the unique case of the Teachers' Investment and Housing Cooperative, an organization took on the characteristics of a financial institution when it, in fact, was governed by legislation which did not impose the degree of regulation common to other financial institutions. How can we avoid a repetition of the Teachers' case in the future? How must we ensure each institution is governed by appropriate legislation?

Financial institutions support diversification for two major reasons - portfolio management and competition.

Financial institutions spread risk by geographic diversification and by investment of a certain percentage of funds in mortgages, consumer and commercial loans, government bonds, and equities. Financial institutions try to match loans and deposits to protect liquidity and margins. Their capacity to do so depends on the powers they are given. These powers have been historically restricted on the premise corporations could not prudently manage broader powers without encountering conflicts of interest.

The second reason is competition. Consumers want better products and services. Debit cards, "universal" insurance, car loans which include interest only payments on part of the value, car loans which include insurance against depreciation loss in write-off accidents, and self-directed RRSP's, are some examples of new products introduced in recent years. Consumers are more willing to move funds from one financial institution to another as interest rates fluctuate.

Does current legislation allow firms to meet their needs to diversify? Should competition and client protection be equally-weighted objectives in discussions surrounding diversification? Should diversification take place industry by industry?

Evolution versus Revolution

Should changes to facilitate diversification be implemented incrementally or should an entirely new regulatory framework be implemented on a specific date? The British opted for the latter. What are the advantages or disadvantages to either approach? What would be the best possible timing for British Columbia, national, and international firms to diversify? Finally, has the timing for British Columbia and Canada already been determined as a result of national and international factors?

International Competition in British Columbia Firms

Can more of our financial institutions be internationally competitive? Should these firms be supported in moving to other jurisdictions or in syndicating? How high a priority should reciprocity have in our approach to international diversification? How will the federal free trade initiative affect efforts to foster diversification? Should the question be answered on a sectoral basis, or on a nation to nation basis?

Credit Union Role

Will diversification pressures be different for credit unions? Is there any reason to treat credit unions differently than other financial institutions? Are special safeguards or incentives required? Should credit unions be allowed to operate extra-provincially and internationally? Would diversification conflict with the basic co-operative philosophy of the credit union movement?

Corporate Structure

For both financial and competitive reasons, corporations are experimenting with a variety of corporate structures for diversification. The reliance on holding companies and on affiliated and subsidiary corporations has grown. Correspondingly, issues have emerged with respect to the corporate structure within which a financial institution operates.

Assuming the financial institution can continue to be effectively managed and regulated for liquidity and solvency purposes, is it good public policy to continue segregation of the non-financial from the financial sector of the economy? Segregation was traditionally based on the premise that a combination of financial and non-financial firms would create unfair competitive advantage and would increase the risk of insolvency. Combined firms in Japan and West Germany have enjoyed success. Would the traditional views change, given increased international exposure of Canadian markets?

Should a parent company which owns a financial institution be required to be a non-operating holding company? Under what conditions should an active operating parent direct the operation of a financial subsidiary?

Financial institutions legislation typically allows firms to conduct certain types of business and prohibits others. Banks are further allowed to engage in "activities reasonably incidental to banking." The federal Trust Company Act permits "reasonably ancillary" business. A liberal interpretation of these incidental or ancillary powers is often offensive to other institutions and competitors, such as computer services

bureaus, which are more severely restricted in their business dealings.

What challenges do different types of corporate structures present for liquidity and solvency? Is corporate concentration an important consideration? Should regulation of liquidity and solvency extend beyond the regulated entity to include other members of the conglomerate?

Distribution Networks

Financial products can be distributed through many channels:

- branch offices;
- agency agreements (either exclusive or multiple);
- brokerage firms;
- affiliated firms; or,
- common carriers (whether electronic or by mail).

Some of the retail selling arrangements are regulated by government; others are self-regulated, or fall outside the regulatory scheme. This poses challenges when financial institutions perform only core functions, and is resurfacing as the four pillars erode.

Concerns focus on the ability of single firms to offer a range of financial services, the ability of the consumer to identify risk, the possibility of increasing conflict of interest, and cross-subsidization. How significant are these concerns?

A number of regulatory and administrative tools can be used to address these concerns. Licensing, deposit insurance, know-your-client rules, disclosure or prospectus requirements, and the power for courts to rescind obligations in the event of misrepresentation or conflict of interest are all possible. Which are most appropriate for British Columbia?

Commercial Lending

At the heart of the diversification debate is the issue of the commercial lending capacity of non-banking institutions. To what extent should commercial lending of non-banks be restricted? If restricted, how is this to be accomplished?

What criteria should be used in deciding whether to restrict entry of financial institutions into other types of financial intermediation? Should the onus be on government to demonstrate the public protection requirement in cases where investment powers are restricted?

4. REGULATION OF FINANCIAL INSTITUTIONS

Appropriate legislation fosters consumer confidence which promotes economic development. Effective regulation of financial institutions is particularly important because of the responsibility inherent in using other people's money and the importance of financial institutions to both public confidence and economic activity. Financial institutions' ability to provide loans well in excess of their paid up capital means the public's access to borrowing is enhanced; it also means careful stewardship is mandatory. Governments are rightly concerned that those who operate financial institutions are honest, prudent and competent.

Failures of financial institutions in the 1980s have focused attention on standards of care for owners and directors, better controls against self-dealing, an expanded role for external auditors, higher liquidity and solvency standards, and improved regulatory supervision.

The following sections of the discussion paper will discuss these issues, as well as issues related to the direct customer interest in their purchase of services from the full range of financial institutions.

Finally, the paper will focus on two types of financial institutions where the government has been examining the need for early action - trust companies and credit unions.

Issues Regarding Financial Institutions Generally

Standard of Care for Owners and Directors

Because they are custodians of their clients' funds, those who direct the activities of financial institutions bear a greater responsibility than do owners and directors of other types of firms. British Columbia legislation governing certain types of financial institutions (the Credit Union Act, for example) confirms the obligations of directors. Should all financial institutions legislation require a standard of care for directors and owners beyond the normal responsibility for protecting the shareholders' interest?

Self-Dealing

One of the major threats to the liquidity or solvency of financial institutions is the abuse of self-dealing. Such abuse occurs when owners and management invest depositors' funds in their own enterprises in the pursuit of their own interests, potentially at the expense of their customers' interests. Self-dealing can cause losses by depositors, minority shareholders and investors.

One way to avoid abuses of self-dealing would be to institute a ban. In some circumstances, self-dealing enables institutions to make more efficient use of facilities and resources. How can self-dealing abuse be controlled without banning non-arms-length transactions which enhance the value and efficiency of financial institutions? At the heart of this issue lies the challenge of establishing the fair value of the transaction. While a broad ban would be simpler from a regulatory point of view, possible exemptions to a ban are under consideration. It would be helpful if financial institutions could identify examples of self-dealing which do not jeopardize depositor interests and should be allowable.

The most effective means of preventing abuse of self-dealing is diffused ownership. Should widely-held financial institutions, therefore, be considered exempt? The ease of fair valuation and materiality are other criteria under consideration for exemption from a general ban on self-dealing.

More comprehensive disclosure requirements and broader responsibility of boards of directors are other means to reduce abuses of self-dealing.

Non-arms-length transactions could be reviewed by independent directors or the regulator to ensure an institution's interests are protected.

What type of non-arms-length transactions are appropriate and should be exempted from a ban? How could more comprehensive disclosure be implemented? Could broader duties and responsibilities for boards of directors take the place of more comprehensive disclosure?

Conflicts of Interest

Conflicts of interest can impose substantial losses on individual customers and threaten confidence in financial institutions. Conflicts of interest occur, for example, when a financial institution in its intermediary role can choose between the interests of an affiliate and the interest of one or more customers.

The most effective way to prevent conflicts of interest is to separate the functions subject to the conflict. Traditionally, separation by core functions has constrained conflicts of interest. However, separation of functions is eroding. International and market forces will continue that erosion, as diversification enables financial institutions to offer new products and product lines.

Another approach under consideration would incorporate a combination of corporate structures and policies to restrict the flow of information between affiliates. While no system

can prevent fraud, additional prohibitions on affiliates dealing with common clients could help prevent conflict of interest abuses.

What financial institutions functions require separation? What would be the most effective means of separation -- by restricting flows of information between affiliates or by prohibiting common clients?

Where are abuses most likely to occur? Are there any conflicts of interest that should not be subject to tighter restrictions?

The External Auditor in the Financial Marketplace

External audits increase the likelihood that an institution's financial statements are complete and accurate.

Issues respecting the role of the auditor include:

- ° enlarging the audit's scope to include areas of concern to the regulator;
- ° relying on external auditors to complement government field examinations;
- ° balancing internal controls, government examinations and external audits; and,
- ° a requirement to establish audit committees of the board of directors.

Disclosure and Good Business Practice

As markets diversify, concerns increase about what the public should expect from suppliers of financial services. British Columbia is committed to ensuring consumers have access to the information necessary to make prudent choices about their purchases. Would the use of a standard disclosure form for the consumer, prior to purchase, be useful? Would the requirement to provide a disclosure form need to be in legislation? The information a depositor or investor may need could include:

- ° Sales - What does the product cost? What are the fees and commissions? Is there a cooling-off period? Who is selling the product? Who is producing it? Who is reinsuring it? Who is acting as trustee?
- ° Insurance - Is any part of the product covered by the Canada Deposit Insurance Corporation (CDIC) or the Credit Union Deposit Insurance Corporation (CUDIC)?

- ° Risk - Are the funds segregated? How are they protected from other funds in the supplier institution? What is the credit rating of the institution? Is it on a regulatory watch list?
- ° Product - Is it a single item or part of a bundle? If a bundle, what are the other items? What does each item cost?
- ° Market - How is the product selling? What is the cost of conversion to other products? Can it be easily assigned? How profitable has investment in this product been? Are any claims being made about future performance?
- ° Guarantee - Does the seller guarantee any specific return? Can the conditions of the guarantee be enforced?
- ° Regulatory authority -- Is there legislation governing the product being sold? What body is responsible if complaints arise?

Customer and Financial Institution Responsibility

Disclosure is only a first step in ensuring that customers, savers and investors are fairly treated in the marketplace.

What standards should we expect of financial institutions in selling their product? The complexity of the financial services marketplace has increased with competition, innovation, and technology. Clients will continue to look to financial institutions and the regulator for a better understanding of their rights and obligations within this rapidly changing environment. Complaints have been heard that investors didn't know, weren't told, or were misled. What are the responsibilities of both the customer and financial institution in that regard?

As a fundamental principle, customers should bear a responsibility for safeguarding their own interests. Customers must keep informed and educated, and must exercise common sense and discretion when conducting financial transactions. Customers share responsibility for ensuring an orderly marketplace.

What can reasonably be expected from the customer? Is it reasonable to assume that customers understand the difference between a deposit and an investment? Is it reasonable to expect customers to understand that not all financial transactions or instruments are insured and that there is some obligation to ask whether both the institution and the deposit are insured?

Is it reasonable to expect the customer to know that deposit insurance has limits and that amounts over that limit are not insured?

Finally, should regulators assume customers understand the relationship between the risks involved in investing and the rates of return paid?

Intergovernmental Relations and the Regulation of the Financial Marketplace

British Columbia's financial sector develops within national and international markets. Therefore, it is imperative to enhance "harmonization" among regulators, deposit insurers, and ministers at both the provincial and federal levels.

Harmony in regulation can mean different things. Consultation requires one jurisdiction to obtain the input of other jurisdictions prior to making regulatory changes, policy declarations or legislative changes.

Co-ordination takes consultation a step further. A concerted effort is made by all jurisdictions to minimize potential administrative and legislative gaps or conflicts which may arise out of one jurisdiction's initiatives.

Joint decision-making implies a voluntary surrender of autonomy by jurisdictions to a joint body. It obligates jurisdictions to exercise their own powers subject to collective constraints.

Steps must be taken to build these three key relationships. At a minimum, regulators in one jurisdiction should be aware of the implications of their actions for regulators in other jurisdictions, and for companies which operate across their borders.

Regulatory action of an extraordinary nature, such as application for a court-ordered liquidation, currently requires intervention by the federal or provincial minister responsible. Ministers may consult with counterparts elsewhere when interprovincial or national firms are involved.

Relationships between regulators and the federal deposit insurers must be clarified. Should harmonization apply specifically to deposit insurance? Is there a need for a standard deposit insurance limit for all financial institutions? At what level should it be set? Should the limit vary to take local circumstances into account and if so, how?

How much further should harmonization proceed? In the House of Commons report on financial institutions (the Blenkarn Report), a new national agency to consolidate responsibilities of federal regulators, provincial regulators and the CDIC was proposed. There appears to be an intergovernmental consensus that such a step would not be appropriate. But, is there a need for a more formal and co-ordinated decision-making body with respect to financial institutions? Should this decision-making body be set up even if it requires jurisdictions to cede authority to that new body? Is further delegation to the federal government, for example, with respect to trust companies, desirable?

Current Progress

The British Columbia Minister hosted a meeting of Ministers responsible for the regulation of financial institutions on March 3-4, 1986 in Vancouver. They agreed to several initiatives aimed at securing federal-provincial co-ordination of financial institutions regulation, while respecting each jurisdiction. These initiatives include:

- ° holding regular federal-provincial ministers' meetings, with a continuing committee of officials, to facilitate consultations and development of co-ordinated policy responses to changes in the industry;
- ° enhancing information sharing among jurisdictions and the CDIC;
- ° working towards a data base on federal and provincial financial institutions, as well as a directory of ownership, to provide a sounder basis for decisions of regulators; and,
- ° ensuring consultation in cases when the interests of more than one jurisdiction are involved in decisions to rehabilitate or liquidate a financial institution.

This fall, Ministers responsible for financial institutions will meet again to develop these initiatives further. Are there additional areas that could be the subject of joint governmental action?

Trust Company Act Reforms

British Columbia's Trust Company Act has not been subject to a major review for some time. Requirements for registration, standards, monitoring, and enforcement need to be streamlined and modernized. Compliance costs may be reduced, thereby encouraging formation of new, or expansion of existing, trust companies. It can also provide for regulators, acting in the

public interest, to secure information and take the preventive, rehabilitative or enforcement action necessary.

Nine major areas of regulatory reform are under consideration. They are:

- ° expansion of the scope of the registration review process, for example, to cover agents of trust companies;
- ° raising minimum capital requirements and qualifications of directors, officers and major shareholders;
- ° providing flexibility to establish more current financial standards, for example, regarding minimum liquidity;
- ° expansion of prohibitions against non-arm's length transactions;
- ° expansion of disclosure requirements for both financial and non-financial data;
- ° expansion of the Superintendent of Financial Institution's examination role, for example, by ordering independent appraisal of asset values and by using specially appointed auditors;
- ° expansion of the superintendent's and minister's rehabilitative and enforcement powers, for example, by imposing terms and conditions on registration and by temporary freezing of assets;
- ° establishment of a formal hearing and appeal process for regulatory decisions; and,
- ° increased penalties for contravention.

Legislation will be drafted on the basis of response to these proposals. Are any additional areas of legislative change required?

Credit Unions - Long Term Regulatory Reform

Credit union legislation, while routinely modernized, may not reflect the diversity now apparent within British Columbia's credit union movement. With 976,000 members, 128 credit unions, and \$6.3 billion in assets, this sector's importance to its members and the economy is clear. The strength of most of the credit unions, backed by a sound regulatory scheme, has enabled our credit union movement to weather the difficult economic times. It is important, however, to examine how our regulations accommodate the ambitions of various segments of the movement.

Credit unions are established to benefit their members. Different levels of discipline and accountability are incumbent on credit unions because of this relationship.

Credit unions are regulated under legislation which is kept up to date by regular amendment. The regulator has strong supervisory and rehabilitative powers. As well, there is a well-defined balance between the respective roles of the regulator and the independent Credit Union Deposit Insurance Corporation (CUDIC).

To provide for the future development of credit unions, is there a need for a new category of credit union with increased powers to diversify? Credit unions want to remain competitive and to maintain their co-operative roots. As other financial institutions are granted new powers and enabled to offer new distribution networks, some credit unions in British Columbia may want to be able to provide a similar range of services. What criteria should be used to determine which credit unions should be granted additional powers? Should criteria be based on size and financial health? Should different capitalization and funding requirements be set? Should there be limits on the range of activities that credit unions can undertake? What additional sources of capital should be available to credit unions? Are present accountability requirements sufficient for diversification?

Insurance

The vast majority of insurance firms active in British Columbia are incorporated in other jurisdictions. Emerging insurance industry issues raise questions, including:

- ° is the level of regulation of insurance agents appropriate?
- ° should insurance companies be allowed to accept deposits?
- ° should door-to-door pyramid selling of term life insurance by part-time sales people be prohibited?
- ° are insurance societies, such as those selling automobile warranties, financially healthy?
- ° is it appropriate for independent insurance agents to also sell trust company or credit union guaranteed investment certificates?

6. CONCLUSION

This paper has raised a number of issues about the economic development of the financial sector and regulation of financial institutions. Many more may also require attention. Views are welcome not only on the areas which have been explored, but also on emerging issues or trends that warrant study to help build the future of this important sector of the British Columbia economy.

Appendix iGLOSSARY

AGENCY AGREEMENT

A legal arrangement whereby a person or company is appointed to conduct limited types of business, or sell limited types of products and services, on behalf of a financial institution.

AFFILIATED COMPANY

An operating corporation related to other operating companies through common ownership by a parent corporation. The affiliated company does not necessarily undertake specific activities related to the parent or other affiliates.

COMMON CARRIER

A common facility for transmission and distribution of information, which is shared by users of the facility.

CROSS SUBSIDIZATION

When a company uses assets from one business to support another business.

DIVERSIFICATION

The ability of an individual firm or industry group to move into areas of business not traditionally within their spheres of activity. Diversification for financial institutions is regulated by the government.

FINANCIAL AND MARKET INTERMEDIARIES

Financial intermediaries are deposit-taking institutions, insurance companies, providers of pension funds and consumer finance companies. Market intermediaries are securities firms. Both types of intermediaries facilitate the transfer of excess capital from savers and lenders to borrowers and investors.

FOUR PILLARS

A term used to describe Canada's four main financial institutions: banks, trust companies, insurance companies and investment dealers.

INTERNATIONAL FINANCIAL CENTRE

A term to describe a geographic location where international financial transactions are conducted or where international financial institutions congregate to do business.

LIQUIDITY

Short term solvency, or the ability to pay short-term debts or withdrawals during the normal course of business.

NETWORKING

Common or shared distribution arrangements for financial products and services between affiliated and/or non-affiliated institutions.

OPERATING VERSUS NON-OPERATING PARENT COMPANY

Holding companies do not operate, that is, they do not perform activities, except those involved in holding the ownership of other companies.

PROSPECTUS

A legal document which describes securities being offered for sale to the public, conforming with requirements set out by government.

SELF-DEALING

A non-arm's length transaction between a financial institution and its major shareholders, directors or senior officers, or with other companies with which they are affiliated, or between a financial institution and its subsidiaries and affiliates. (Arms-length transactions are those between unrelated independent parties.)

SOLVENCY

The financial status of a company, characterized either by its ability to meet its financial obligations as they become due, or by the fact that its assets exceed its liabilities.

SUBSIDIARY COMPANY

A corporation owned by another corporation.

Appendix iiACTIONS TAKEN BY THE MINISTRYAdapting the Organization

The responsibility of the Ministry of Consumer and Corporate Affairs includes the regulation of both market and financial intermediaries. A number of changes have been made in the past year to modernize the Ministry organization.

Operations have been restructured with establishment of the Office of the Superintendent of Financial Institutions which consolidates the regulation of financial intermediaries, such as credit unions, trust companies and insurance companies into one branch.

A specialized Investigations Branch has been formed in order to more effectively serve the needs of both the Superintendent of Brokers and the new Superintendent of Financial Institutions. These reorganized investigative capacities will be supplemented, when necessary, by outside expertise for special cases.

As well, the ministry has made a number of legislative changes, many of which are highlighted below. Overall, the net effect will be to improve public protection, by weeding out undesirable operators in the marketplace and by setting standards for those who are eligible to participate.

Securities Regulation:

In December 1985, a new Securities Act was passed by the Legislature and is expected to be proclaimed in 1987. The Chairman of the Securities Commission was appointed in July, 1986. The Securities Commission will make policy and hear appeals on administrative decisions of the Superintendent. A firmer legal basis for continuous disclosure of material changes that relate to a company's securities is provided by the new Act. The Commission or the Superintendent is also given power to immediately halt trading in a security, if unusual or unexplained fluctuations in price or volume occur.

At the Vancouver Stock Exchange (VSE), rule changes focused principally on regulatory policies, which permitted junior companies to go public at a very early stage in their economic development. Local Policy Statements focused on escrow share incentive proposals for inactive listed companies, financial reporting, transfers of control, and the involvement of one individual with a number of listed companies. Finally, changes were directed towards the first primary distribution and the role of VSE members in this process.

Outside expertise now assists Ministry staff in vetting specific technical areas of prospectuses, such as mining reports, feasibility studies, and high technology proposals. This outside advice contributes to the efficiency of the disclosure process in securities regulation. The Superintendent's office is also currently developing an in-house market surveillance system to monitor securities trading. This system will complement the VSE's own role in this area. Administrative changes at the VSE have included the introduction of disclosure of violations made by member securities firms.

Within the securities industry itself, public protection will be improved by changes proposed for the National Contingency Fund. This fund protects uninvested balances of clients of a securities firm in the event of an insolvency. Additional insurance coverage is being arranged to supplement the present resources of the fund.

Commodity Contracts Regulation:

New legislation has been passed to deal with this specialized area of the securities market; namely, commodity options, futures contracts and futures options. The principal focus of the new legislation includes the following:

- registration of dealers and advisers;
- recognition of exchanges for the trading of commodity futures contracts;
- approval of contracts by the regulator;
- standards of operation, such as disclosure requirements, for dealers and advisers; and,
- broad disciplinary and enforcement powers for the Superintendent, similar to those found in securities regulation.

Specific new measures for investor protection include provisions for segregation of client funds and rules governing discretionary trading.

Property and Casualty Insurance Companies:

Canadian jurisdictions and the insurance industry are establishing a compensation fund to protect small policyholders. The fund will be financed by industry assessments. Legislation will soon be introduced to enable British Columbia to participate in the fund.

Regulators have developed, on a national basis, a common set of solvency standards and tests for both life and general insurance companies. In addition, British Columbia has recently developed a computerized monitoring and reporting system which provides early warning of financial problems in British Columbia insurers.

Appendix iiiSELECTED FINANCIAL STATISTICS

TABLE 1:

Financial Assets of Canadian Financial Institutions, 1967 and June 1984

	Billions of dollars		Per cent of system assets	
	1967	1984	1967	1984
Major deposit-taking institutions				
- Chartered banks	24.9	213.9	34.3	37.4
- Trust and loans	7.0	63.3	9.6	11.1
- Credit Unions and Caisse Populaires	3.3	40.2	4.5	7.0
Contractual-savings institutions				
- Life insurers ⁽¹⁾	12.8	63.4	17.6	11.1
- Trusteed pension funds	8.0	83.8	11.0	14.6
Other financial institutions				
- Private sector ⁽²⁾	10.8	62.9	14.9	11.0
- Public sector ⁽³⁾	5.9	45.1	8.1	7.9
TOTAL	72.7	572.6	100.0	100.0

(1) Includes their accident and sickness insurance operations and segregated funds.

(2) Includes property and casualty insurance companies, sales finance and consumer loan companies, investment dealers, mutual funds, Quebec savings banks, mortgage investment trust corporations, financial leasing companies and business financing corporations.

(3) Excludes the Bank of Canada.

Source: Financial Flow Accounts, Canada Gazette, and Bank of Canada Review.

Source: Federal Green Paper, 1985.

TABLE 2:

Assets by Type of Deposit-Taking Institutions December 31, 1984

	<u>Billions of Dollars</u>		
	<u>B.C.</u>	<u>Canada</u>	<u>B.C. Canada</u>
Credit Unions	\$6.3	\$40.2	15.7%
Trust Companies	10.9	63.3	17.2%
Banks	<u>35.5</u>	<u>213.9</u>	<u>16.6%</u>
	\$52.7	\$317.4	16.6%

TABLE 3:

Deposit-taking Institutions in B.C.¹

	<u>Credit Unions</u>	<u>Banks</u>	<u>Trust</u>
B.C. Assets (billions \$)	6.3 ²	35.5 ³	10.9 ⁶
# of firms	135 ²	sched A - 10 ⁴ sched B - 30 <u>total 40</u>	25 ⁷
# of locations	315 ²	sched A - 796 ⁴ sched B - 39 <u>total 830</u>	119
# of ATMs	145	433 ^{4.5}	10. ⁸

1. As of December 31, 1985, unless otherwise stated.
2. Credit Union Reserve Board, 1985, Annual Report.
3. As of third quarter 1985, Bank of Canada Review.
4. Canadian Bankers' Association.
5. As of January 31, 1986.
6. Estimated, as of December 31, 1984.
7. Does not include 21 non-deposit-taking trust companies registered under the Trust Company Act.
8. Trust Company Association of Canada.

TABLE 4: Activity on the Vancouver and Toronto Stock Exchanges

	<u>Vancouver Stock Exchange 1984-85</u>	<u>Toronto Stock Exchange 1984</u>
Share Value Traded	\$1,968,266,000	\$26,681,943,965
Number of Transactions	1,324,000	2,180,032
Share Volume Traded	2,108,175,000	2,440,021,743
Revenue	\$ 15,869,000	22,196,000
Working Capital, end of year	\$ 3,373,000	4,180,000
Member Firms	48	79
Financings	\$ 194,368,000	N/A
Year end	March 31	December 31

Appendix ivCHRONOLOGY OF KEY DOMESTIC AND INTERNATIONAL EVENTS

DOMESTIC

1967 Federal deposit insurance for banks and trust companies is introduced across Canada. Quebec introduces similar provincial program for Quebec depositors.

1980 New federal Bank Act gives chartered banks new powers.

1982 Federal government introduces proposals for new trust company and savings bank legislation.

Ontario experiences problems with trust and loan industry. Crown Trust, Greymac Trust and Seaway Trust are involved at the Ontario level, while Seaway Mortgage and Greymac Mortgage are involved at the federal level. An 11,000-apartment transaction in Toronto is a key factor in the ensuing investigation.

1983 Saskatchewan passes new trust and loan legislation.

Ontario amends its trust and loan legislation in response to urgent regulatory needs as result of Crown Trust issue.

Ontario introduces discussion paper on long term reform of provincial trust company regulation. Issue of commercial lending is addressed.

Regulators terminate Crown Trust and related companies in Ontario. CDIC is involved in the payment of depositors' claims and assistance for mergers. Ontario appoints Morrison Inquiry for further investigation.

1984 Quebec amends its Insurance Act to give insurers the discretion to exercise a broad new range of powers in the financial service sector, including subsidiaries with deposit-taking activities.

1985 Federal government issues major discussion papers on reforms to the regulation of financial institutions in Canada. Key areas of emphasis include improved supervision by regulators and prospects for diversification by the various financial service sectors.

Federal government also initiates a review of the Canadian deposit insurance system.

British Columbia initiates discussions on international financial centres.

Five trust and loan companies terminate operations in Canada due to financial difficulties, including Pioneer Trust and Western Capital Trust.

After a joint rescue attempt by both governments and banks, regulators close Canadian Commercial Bank. Regulators also close Northland Bank. Federal government initiates Estey Bank Inquiry to investigate the situation.

Victoria Mortgage Corporation is placed in receivership in British Columbia.

Teachers Investment and Housing Co-operative makes proposal to its members in British Columbia.

British Columbia passes new Securities Act, with final proclamation to take place in 1986 with new regulations in place.

Manitoba introduces new credit union legislation for discussion.

Federal House and Senate Committees issue respective reports on reforms to the financial institutions sector. Both support the general need for broader diversification opportunities in the industry.

1986 Saskatchewan's new Credit Union Act takes effect.

Federal budget announces designation of both Montreal and Vancouver as international banking centres, with appropriate tax measures pending.

British Columbia hosts the first federal/provincial conference for Ministers responsible for financial institutions.

British Columbia proclaims new Commodity Contract Act.

British Columbia initiates discussion on financial institutions, regulatory reform and economic development in the Province.

INTERNATIONAL -- United States

1980 Major legislative reform for financial institutions. New powers are granted to banks and savings and loan associations. Interest rate ceilings are phased out. Monetary control by the federal government is improved.

- 1981 Significant number of banks and savings and loan associations fail due to financial difficulties. Among them is the Penn Square Bank, whose failure caused the largest federal deposit insurance payoff in history and created serious financial difficulties for a number of other banks, including Continental Illinois Bank. Federal government initiates review of the national deposit insurance system.
- 1982 Second round of major legislative reform for financial institutions. Authorization of new powers for deposit-taking firms includes "money market deposit accounts". Savings and loan associations are granted the capacity to make commercial loans. Regulators' emergency powers are strengthened to deal with crises in the various industry sectors.
- 1983 A federal regulatory agency approves legality of state banks offering discount brokerage services or underwriting corporate securities.
- 1984 The Vice-President's Task Group on Regulation of Financial Services issues its final report. A sweeping set of recommendations for regulatory reform is made including a realignment of the major financial regulatory agencies.

An unprecedented number of commercial banks and savings and loan associations continue to fail. The Continental Illinois National Bank is bailed out with a multi-billion dollar financial assistance package from both government and industry.

INTERNATIONAL--United Kingdom

- 1984 Government discussion paper on role of building societies is released. Expansion of their powers is considered.
- 1985 Government discussion paper on financial services in the United Kingdom is released. Self-regulation is suggested for some sectors.
- 1986 The end of fixed broker commissions and the opening of the stock exchange to outside membership is scheduled for October. This major transformation in London continues to spark numerous mergers between British and foreign banks and securities dealers.

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